

Message Text

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ACTION SS-14

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SUBJECT: SITUATION REPORT, DECEMBER 13

REF: (A) STATE 267168; (B) LONDON 19945

1. THE IMF LOAN AND STERLING BALANCES. FINANCIAL TIMES
FRONT PAGE'S STORY FROM WASHINGTON BY DAVID BELL, HEAD-
LINED "IMF MAY RELEASE \$3.9 BILLION BY INSTALLMENTS".
THE IMF, ACCORDING TO BELL, MAY RELEASE ONLY THE FIRST
\$1 BILLION OF ITS \$3.9 BILLION LOAN TO THE UK SOME TIME
NEXT MONTH, WITH THE REST OF THE MONEY BEING PROVIDED
IN TRanches EVERY THREE MONTHS DURING THE NEXT TWO
YEARS. THE FUND WILL PROVIDE FOR TARGETS WHICH WILL
HAVE TO BE MET AT THREE MONTH INTERVALS. PERFORMANCE
CLAUSES WILL BE REVIEWED EXTENSIVELY AFTER THE FIRST
YEAR. FIRST INSTALLMENT OF \$1 BILLION WILL MAKE UP
ONLY PART OF THE FALL OF THE UK OFFICIAL RESERVES
FOLLOWING LAST THURSDAY'S REPAYMENT OF CENTRAL BANK
SWAP. SENIOR IMF STAFF CONSIDER THAT TARGETS AND CONDI-
TIONS ARE FAIRLY DRASTIC AND THEY WILL TIE THE BRITISH
GOVERNMENT FAIRLY CLOSELY TO WHAT HAS BEEN AGREED WITH
THE FUND. ARTICLE NOTES THAT THERE APPEARS TO BE SOME
SUPPORT AMONG EUROPEAN COUNTRIES FOR THE SO-CALLED
TARGET SAFETY NET.

IN A TIMES ARTICLE ENTITLED "NO AMERICAN PLEDGE
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YET TO SUPPORT SAFETY NET FOR THE STERLING BALANCES" BY

FRANK VOGL, DATELINED WASHINGTON, IT IS REPORTED THAT SIR DEREK MITCHELL FLEW TO WASHINGTON OVER THE WEEKEND FOR DISCUSSIONS WITH FEDERAL RESERVE CHAIRMAN ARTHUR BURNS AND UNDER SECRETARY OF TREASURY EDWIN YEO. THE BRITISH, ACCORDING TO SOME SOURCES IN WASHINGTON, HAVE BEEN OVERCONFIDENT ABOUT THE SUPPORT THEY CAN OBTAIN FROM THE AMERICANS OVER STERLING BALANCES. MR. CALLAGHAN IS BELIEVED TO HAVE TELEPHONED PRESIDENT FORD IN THE PAST COUPLE OF WEEKS TO OBTAIN HIS SUPPORT. A TOP AMERICAN OFFICIAL STATED, HOWEVER, THAT THERE "HAS DEFINITELY NOT BEEN A PROMISE OF UNITED STATES AGREEMENT

OVER THE WEEKEND, THE CHANCELLOR FIRMLY STATED HIS INTENTION "TO GET IT RIGHT THIS TIME AND NOT TO TAKE ANOTHER BITE AT THE CHERRY". THIS WAS A TACIT RECOGNITION OF THE INEFFECTIVENESS OF THE STEP BY STEP APPROACH THE H.M. GOVERNMENT HAD BEEN FOLLOWING SINCE THE INTRODUCTION OF INCOMES POLICY IN AUGUST OF 1975. HEALEY STRONGLY HINTED THAT THE COMING PACKAGE WOULD CONTAIN ALL THE MEASURES NEEDED SO AS TO AVOID DISSIPATING THEIR IMPACT. HE ALSO INDICATED THAT H.M. GOVERNMENT EXPECTS THIS YEAR'S (FY 76) PSBR TO BE ABOUT 11.0 BILLION POUNDS, THE FIRST OFFICIAL REDUCTION IN LAST JULY'S ESTIMATE OF 11.5 BILLION.

MEDIA SPECULATION ABOUT THE CONTENT OF THE CHANCELLOR'S ECONOMIC PACKAGE GROWS MORE INTENSE. ONE NEW REPORT SAYS THE CHANCELLOR'S PACKAGE WILL INCLUDE A FURTHER ACCELERATED INVESTMENT SCHEME WORTH ABOUT 100 MILLION POUNDS DESIGNED TO ENCOURAGE INDUSTRY TO BRING FORWARD PLANNED INVESTMENT PROJECTS.

PROPOSED CUTS IN DEFENSE SPENDING, RUMORED TO BE IN THE 100-200 MILLION POUND RANGE, PRODUCED AN UNUSUAL MEETING BETWEEN THE PRIME MINISTER AND THE MILITARY CHIEFS OF STAFF FRIDAY EVENING. THESE CUTS WOULD BE IN ADDITION TO THOSE (100 MILLION POUNDS) ANNOUNCED LAST JULY. NO DETAILS OF THIS MEETING WERE REPORTED TO THE PRESS. HOWEVER, LEFT-WING LABOR MPS IMMEDIATELY RESPONDED BY TELLING THE GOVERNMENT IT COULD FACE A LIMITED OFFICIAL USE

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REVOLT IF DEFENSE IS NOT CUT ALONG WITH HOUSING AND SOCIAL SERVICES.

SOME ELEMENTS IN THE LABOR PARTY ARE ALSO CONCERNED ABOUT REPORTED CUTS IN OVERSEAS AID (WHICH ESCAPED BEING INCLUDED IN LAST JULY'S CUTS).

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2. IT WAS ANNOUNCED ON FRIDAY THAT THE PAYMENT OF 370 MILLION POUNDS IN SPECIAL DEPOSITS DUE DECEMBER 14 WOULD BE POSTPONED UNTIL JANUARY 28. THIS IS THE SECOND POSTPONEMENT OF THIS PAYMENT WHICH HAD ORIGINALLY BEEN SCHEDULED TO BE PAID ON NOVEMBER 15. AS WAS THE CASE WITH THE PREVIOUS POSTPONEMENT, THIS ONE IS DESCRIBED AS A TECHNICAL ADJUSTMENT WHICH DOES NOT SIGNIFY A CHANGE IN MONETARY POLICY. THE BANK OF ENGLAND IS REPORTED TO FEEL THAT BANKS WILL BE UNDER SUFFICIENT RESTRICTIVE PRESSURE DURING THE NEXT FEW WEEKS WITHOUT THE SPECIAL DEPOSITS PAYMENTS. THIS PRESSURE IS THOUGHT TO ARISE ON THE ONE HAND FROM THE HIGH LEVEL OF GILT SALES WHICH HAVE KEPT MONEY MARKET CONDITIONS TIGHT. ON THE OTHER HAND BANKING STATISTICS RELEASED LAST WEEK INDICATED THAT BANKS HAVE ALREADY EXPANDED THEIR LIABILITIES BEYOND THE LIMITS OF THE "CORSET", AND THE BANK BELIEVES THAT THEY WILL CONSEQUENTLY BE FACED WITH RESTRICTIONS ON LENDING DURING THE NEXT FEW WEEKS.

3. FOREIGN EXCHANGE AND FINANCE: THE MARKET IN STERLING CONTINUED QUIET AND STEADY, CLOSING FRIDAY AT \$1.6705 DOWN JUST \$0.0005 FROM THURSDAY'S CLOSE. ITS TRADE-WEIGHTED DEVALUATION WIDENED TO 44.8 FROM 44.7 PERCENT. THE MARKET WAS BELIEVED TO BE WAITING FOR WEDNESDAY'S ECONOMIC PACKAGE. THE POUND OPENED TODAY AT \$1.6750.

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THE MINIMUM LENDING RATE (MLR) REMAINED UNCHANGED AT 14-3/4 AFTER FRIDAY'S TREASURY BILL AUCTION. BIDDING WAS, HOWEVER, STRONG. 1.585.89 MILLION POUNDS IN BIDS WERE RECEIVED FOR THE 300 MILLION POUNDS IN TREASURY BILLS OFFERED. THE TREASURY BILL RATE WAS UP 0.0121 PERCENT FROM THE PREVIOUS WEEK TO 14.0054 PERCENT. A FALL IN THE MLR IS WIDELY ANTICIPATED FOR THIS WEEK, AS EVIDENCED BY THE SHARP DROP IN THE DISCOUNT HOUSES' BID YIELDS TO NEAR 13-3/4 PERCENT LATE FRIDAY.

GILT PRICES ROSE AROUND 1/4 IN ALL MATURITIES ON FRIDAY, REFLECTING AN ANTICIPATED FALL IN MLR AT THIS FRIDAY'S TREASURY BILL AUCTION. THERE WAS SOME DEMAND FOR THE 13 PERCENT 1980 TAP STOCK, BUT THE APPLICATION FOR THE NEW 15-1/2 PERCENT 1998A DID NOT APPEAR STRONG.

THE EQUITY MARKET CONTINUED TO RALLY AS THE FINANCIAL TIMES INDEX OF 30 ORDINARY INDUSTRIALS ROSE 10.7 PERCENT TO 330.1 ON FRIDAY. THE STRENGTH IN THIS MARKET HAS BEEN ATTRIBUTED TO THE POSTPONEMENT OF THE 370 MILLION POUNDS SPECIAL DEPOSIT PAYMENTS THAT HAD BEEN DUE THIS TUESDAY, AND TO THE REDUCTION IN U.S. PRIME INTEREST RATES.

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